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Joseph L. Weiner

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The correctness of the principles on which balance-sheets are prepared comes frequently before courts and is now occupying the increasing attention of legislatures. Irrespective of legal compulsion, the preparation of balance-sheets is a universal practice. But it is natural that interest in theories of valuation should be liveliest when the preparation of balance-sheets is prescribed by law. This has been so in Germany since 1861.

The balance-sheet provisions of the present German commercial code, adopted in 1897, are substantially the same as those of the 1861 code. The duty to keep books is provided for by section 39 of the present code:

> "Every business must keep books in which its business transactions and the state of its property are to be intelligibly recorded according to the principles of proper bookkeeping."

Section 39 provides also for an opening balance-sheet and an annual balance-sheet thereafter.

EARLY CONTROVERSY

Section 40, which provides, inter alia, how the assets and liabilities are to be valued, is in part as follows:

> ". . . In the inventory and balance-sheet each item enumerated among the assets and liabilities must be set down at the value which ought to be ascribed to it at the date as of which the inventory and balance-sheet are being drawn up.
>
> "Doubtful book debts must be set down at their probable value; unrecoverable debts must be written off."

With the exception of the specific injunction about debts, the operative words are clearly "the value which ought to be ascribed" to the asset or liability. This phrase has an interesting history. In 1857, prior to the unification of Germany, a conference was called to draft a uniform commercial code for the then independent German states. The basis of the conference discussions was a draft prepared by the Prussian representatives. This draft contained only a few valuation rules, to wit, goods and materials were to be carried at the lower of cost or market, merchandise which had depreciated through being stored and machinery worn out by use were to be valued at correspondingly lower figures. No other valuation problems were mentioned.

This section was vigorously attacked in the conference, especially on the ground that it was too specific. To meet this objection, the statute was made to read that the assets and liabilities were to be set down at their "true value." This in turn was changed by substituting "value which ought to be ascribed," leaving the section as above.

This "value which ought to be ascribed" is a far cry from the cost-or-market principle of the Prussian draft. But did the conference intend such a change? Not at all. The conference minutes contain the surprising declaration that the valuation provision is modeled substantially on the original draft.

In the other fields of German law, cost and value were regarded as distinct, almost as opposites. They are still so regarded in most fields of law. Value was generally assumed to mean market or exchange value, variously referred to as verkehrswert, gemeiner wert, verkaufswert. It was natural, therefore, for jurists to interpret the statute in the light of this accepted usage despite the assertion that this was "substantially" the draft provision. In any event, they concluded that "value," as used in a statute and unless qualified by other language, meant legally "exchange value."

This was the situation in the absence of a court decision. In fact, no authoritative decision appeared prior to 1873. In that year an interesting case in valuation arose. A corporation was formed to take over a banking partnership on the basis of the latter's book value. Among the bank's liabilities were gold deposits, payable in specie but not callable for six months. The bank's book entries were in terms of silver thalers, which were legal tender, at current prices for gold. The corporation argued that the gold deposits should have been calculated at the government gold-silver ratio, which was higher, and would, therefore, have resulted in an increase in the liabilities. The court held that the probable price of gold at the time of repayment was to be determined; that the current price and the official ratio were merely facts to be taken into consideration in determining that price. In a dictum the court sought to lay down general valuation principles, as follows:

> "The value which is determinative for the balance-sheet is in all cases the general exchange value in contrast to some figure based solely on wilful individual judgment or pure speculation. The balance-sheet should correspond, with objective truth, to the real state of the property and it follows from this that assets or liabilities which have a market or

exchange value should as a rule be entered in the balance-sheet at such value, whereas for other assets their present objective value is to be determined in some other way. According to this view the idea of a fictitious instantaneous general realization of all assets and liabilities is the concept underlying the balance-sheet; but at the same time the viewpoint is that in reality the continuation and not the liquidation of the business is intended. Therefore, in the determination of the individual values, the influence of liquidation upon the latter is to be left out of account."

This encyclopædic dictum contains many propositions worth investigating further. We are met at the outset with a contrast between exchange value and subjective value, a contrast by no means unique, inasmuch as reproduction cost, actual cost and several other possible bases are fully as objective as market value, and superior, in many circumstances, in the ease and accuracy with which they can be determined.

That the balance-sheet should represent merely those "objective values" envisaged by the court in the second sentence quoted, rather than subjective opinion (estimates) would be vigorously disputed by numerous authorities; moreover, that such objective truth, even where it is desired, is best manifested by market price, where such exists, is not free from doubt.

The most striking proposition of all is the statement of the underlying concept of the balance-sheet, a statement which if it makes sense has none the less baffled even its defenders. Whatever strained construction one may put upon it, it is difficult to escape the contradictio in adiecto—the sale that is not a sale. However, these difficulties were not apparent at the time, and with startling unanimity contemporary writers agreed that all the court meant was "sale price" as a criterion. A typical contemporary paraphrase is that of Endemann:

"According to mercantile theories this value appears to be the sum which the given object would realize at the time in question at an immediate sale."

But the court was not destined to escape so lightly. However logical its interpretation may have been, it did not prove feasible in practice. In practice, sale prices were regularly ignored, as they obviously had to be in the case of fixed assets. The railroads in particular were aggrieved. Since the investment of the roads varied only slightly from time to time, their chief interest was in an accurate profit-and-loss account which would enable them to control rates and measure the relative profitableness of the lines. "Some railroads had no real balance-sheets whatsoever. They called their income and expense accounts balance-sheets." They naturally resented any rule of law which would compel them to show sale values, to say nothing of the ludicrous results.

This issue was squarely presented in a case in 1879. The defendant railroad had issued some 17,000,000 marks in bonds in order to acquire shares of a connecting company, of 20,000,000 marks par value. The shares were carried on the books at cost, i.e., 17,000,000 marks. Plaintiff, a junior shareholder, proved that on the basis of the market quotations for the shares they were worth only 5,000,000 marks and sought an injunction against dividends on the preferred shares until the deficit was made up. The court refused and said that fixed assets might be carried at cost, on the ground that the statute permitted such valuation in the case of assets "which by their nature are not subject to any other measure of their present value."

Later decisions oscillate between the different theories, without apparent efforts to reconcile them. Thus in 1887 the court was positive that according to section 40 cost was not an upper limit any more than it could be used for a plant actually worthless; the value which ought to be attributed to the asset was decisive. The value in question was one which a more or less extensive circle would regard as the price that could be realized if the assets were sold.

In the same decision, however, the court insisted that it was error to ignore the income of a business in establishing the value of the fixed assets. The lower court had said that the balance-sheet should reveal the market price of the individual assets, intimating that the difference between the total so determined and the estimated worth of the enterprise as a going concern might then be separately entered as goodwill. "In doing this," said the supreme court, "the court below ignored what is in fact the most important element in the determination of value, since in estimating the value of the fixed assets of an enterprise the truth is most closely approximated if a value is calculated corresponding to a capitalization of income, taking into consideration the influence of permanent or merely transitory conditions. If we should deny the decisive significance of average earnings in the past we would set ourselves in opposition to every-day experience, which is, that in bargain and sale the figures for past earnings are fundamental to the seller in fixing his price."

It is apparent that instead of clarifying the law this decision involves a contradiction even more vital, and more destructive, than the earlier one. The 1873 decision had an accepted significance—sale value—which, whatever its drawbacks, was at least intelligible and subject to practical application. The present decision, authorizing as it did a consideration of the value of the business as a whole in determining the values of the respective assets, could result only in confusion.

THE CORPORATION LAWS OF 1884 AND 1897

The next step forward was taken by the legislature. In 1870 an unparalleled wave of promotion and stock speculation started in Germany, which came to an abrupt and calamitous end in 1873. Much of the blame for this was placed on the corporation law, and a legislative investigation was instituted with a view to introducing more stringent laws. Examination of the balance-sheets of that period revealed that promoters and their attorneys conveniently interpreted "value" as probable sale price, and they devised balance-sheet values hardly justified by their most sanguine expectations. Huge quantities of stock were unloaded on the assumption that the companies involved had huge earned surpluses.

A new corporation law developed from the investigation and it made numerous changes. Among other things, comprehensive provisions were enacted with respect to balance-sheets and dividends. The basic valuation rules are in section 261 of the present commercial code, which provides:

> "For the preparation of the balance-sheet the provisions of section 40 apply, subject to the following rules:
>
> "1. Securities and merchandise that have an exchange or market value may not be valued higher than the price at which they were quoted at the time as of which the balance-sheet is prepared, or if such price exceeds the cost of acquisition or production, then not higher than the latter.
>
> "2. Other property may be entered at the cost of purchase or production at the highest.
>
> "3. Plant and other property intended not for resale but to be permanently employed in the business may be valued at its cost of purchase or production irrespective of their being worth less, provided a sum corresponding to physical depreciation is written off or an equivalent amount is set up in a renewal fund.
>
> "4. The cost of organization and management may not be carried in the balance-sheet as an asset.
>
> "5. The amount of share capital and of each reserve and renewal fund must be carried among the liabilities.
>
> "6. The balance of profit or loss must be separately stated at the foot of the balance-sheet."

Here the accountant is in more familiar territory. Aside from the inflexibility of these rules, they are still standard accounting practice. A few outstanding features may be briefly noted. Fixed assets are valued at cost less depreciation; current assets at the lower of cost or market; organization expense may not be capitalized (this is more rigorous than is currently demanded). An interesting but not obvious point with respect to fixed assets is the following: the statute provides that current assets *must* be valued at the lower of cost or market; on the other hand, fixed assets *may* be valued at cost less depreciation, "despite a lower value." But suppose that they have a higher "value"? If this "value" is exchange value then section 40 allows it to be entered in the balance-sheet. However, section 261 (2) forbids entering any asset at more than cost. Therefore, cost is the maximum, but no depreciation need be written off in such a case.

The surplus shown on the balance-sheet thus prepared is not entirely available for dividends. Section 262 requires that all paid-in surplus, and also one twentieth of the annual profits, must be credited to a statutory reserve until the reserve is equal to one tenth of the share capital. The reserve may be encroached upon only to cover deficits.

Section 261 is worded misleadingly. It reads as if it merely provided certain exceptions to section 40. In fact, it covers practically the entire field and the major questions of valuation in corporate balance-sheets were set at rest by it.

FINAL INTERPRETATION OF "VALUE"

Important as the corporate legislation was, it applied only to a limited group, whereas all business enterprises in Germany are required by law to prepare annual balance-sheets. This is especially significant since the corporate legislation applied only to the "stock-corporation" (aktiengesellschaft) and not to the far more numerous "limited liability companies" (gesellschaft mit beschränkter haftung). A new era for the other companies may be said to have set in with the publication by H. V. Simon of his *Balance-sheets of Corporations*.

Simon asserted boldly that the words "value to be ascribed" to the asset, as used in the statute, did not refer to any particular value, but left the valuer free to exercise sound judgment. Or, to use his own words, the legislators "chose the somewhat colorless phrase in order to preserve existing commercial practice." This interpretation was not likely to have much effect, nor should we be interested in it, but for the fact that it was supplemented by a definite set of valuation principles. Simon believed that he had found the true principles by an analysis of the nature of the balance-sheet. It was, he admitted, a picture of property but none the less of "the property of a definite personality. Severed from this personality the individual assets assume another character; some are entirely non-transferable, many more change in value when transferred. An article which is significant for one person solely for its use is valuable to another only as an object for exchange. The same article may have a different value in use for different persons according to the means which they are capable of expending on it and according to the use to which they put it. But for the stock corporation or business man, who desires a picture of his financial status, the sale value of property which he intends for use in his business is immaterial, and so is the use value of an article which he intends to sell."

This is an emphatic statement of the now familiar distinction between fixed and current assets. But to Simon it was more than that. He believed that the balance-sheet should take into account not only the purpose for which the asset was used, but also the ability of the owner of the asset to use it profitably.

Unfortunately, Simon offers no clearer explanation of "value in use" than the one quoted.

It is inconceivable that he employed the phrase in the sense in which it is ordinarily used by the economist, e.g., that a bucket of water has great value in use but not in exchange. It is more likely that Simon had in mind some such notion as "value to the owner" for in later portions of his book he suddenly changes from value in use (gebrauchswert) to value to the going concern (betriebswert). In this he has been followed by Staub, the leading commentator on the commercial code, who employs the phrase "value to the business" (geschäftswert).

In analyzing the substitute, we must remember that neither Simon nor Staub was particularly concerned with the valuation of current assets. Either cost or net selling price or the lower of the two for current assets would have been accepted by everybody without any considerable demur. The difficulty lay in the valuation of fixed assets, for which some non-exchange standard had to be created.

What is basic in these alternatives to exchange value is, in the first place, a conviction of the inadequacy of liquidation prices to measure the contribution of fixed assets to the total value of a business, and, secondly, the obvious necessity of taking account of the fact that the asset is used in a going business and for a particular purpose. Assuming, however, that all this is summed up in the phrase "value to the business" it remains to be seen whether this is a serviceable concept for the preparation of balance-sheets. How shall such a value be estimated? If the profit of the business is to be capitalized, there is no ready means of distributing the total value among the individual assets. The balance-sheet —and the statute—require not a value for the business, but the values of the individual assets comprised in the business.

But the application of the rule of "value to the business" involves other and more serious objections. Simon and Staub are both of the opinion that proper application of this rule requires cost less depreciation as the value of fixed assets. But this purely arbitrary figure is hardly "value" to any business. Suppose, for example, that the same machine is used by two companies, the first at a considerable distance from the place of manufacture of the machine and the second at the very place. The usual practice is to capitalize the purchase price plus cost of transportation and installation. It may be, of course, that they are each worth the amounts thus shown by the books, as evidenced by the fact that the respective managements are willing to pay such prices, yet they produce identical services, other things being equal. Suppose, however, that the manufacturer of the machine should move to the place where the first company is situated. Would the second of these companies then be justified in capitalizing an unincurred cost of transportation on the ground that the machine could not then be replaced for less and would be replaced if necessary? And would the other be compelled to deduct the cost of transportation because the machine could be replaced without this expenditure? And if a lower price were to be quoted by the maker of the machine immediately after its purchase by both the companies in question, would both be required to reduce the respective book values on the ground that the value of the machine to each business can be no greater than the price at which it could be replaced? Is the machine worth more to one business because that business operates the machine at a huge profit? And if the business operates at a loss, can the value of the machine to the business ever be said to be equal to cost less depreciation? The endless ramifications of this type of inquiry are, of course, familiar in all valuation study.

This analysis does not discredit the use of cost less depreciation. It does challenge the propriety of calling cost less depreciation the "value to the business" or any similar name. Though Simon's theory bristles with logical difficulties, his practice was familiar. For the sake of the practice, therefore, his theory won popularity. In an amazingly short time, it was the accepted interpretation of the statute, but no stress was laid on the particularistic turn in Simon's work. As thus modified, this view won the approval of the supreme court, in what is still the leading case on valuation. In this case, decided in 1899, the court in considering the valuation of fixed assets said:

> "It is incorrect to say that the profits of an enterprise are to be considered in the balance-sheet. Not the value of the business measured by its returns is to appear in the balance-sheet but the individual real assets according to their value. These separate items of property can not, however, be measured by their profits at all, since the individual asset as such yields no profit. It is true, to be sure, that the individual assets are to be entered in the balance-sheet according to their value to the business (geschaeftswert). But that means only that the value to the business is to be taken, and by no means, as appellant claims, that the value *of* the business has a retroactive effect on the individual assets. By this standard a factory, for example, is to be valued as such. On the other hand, an object which can be bought or erected at a certain price may not be entered in the balance-sheet at a higher figure because it is used in a prosperous business."

In view of the importance of the 1899 decision, a brief comparison of the dicta in this case with the "sale value" of 1873 may be in order. With the interpretation given to the latter, as shown on page 197, the former is clearly in conflict. That it is equally in conflict with the language is by no means clear. The quotation on page 196 shows that the court qualified the sale concept by presupposing a continuance of the business. Logically, this was perhaps also a contradiction. Value to the business, the standard in the instant case, is at least consistent with one of the two contradictory views. That the court was unaware of the contradiction in the earlier case does not impair the force of the consistency. The added fact that the court in 1899 repudiated the idea which had been gaining force, viz., that the value of the business as a whole, as measured by its earning power, was a factor in evaluating the individual assets, brings it closer to the earliest decision than to any other previously decided. On the other hand, the court has purged itself of the idea of immediate sale. This is one of the products of Simon's work. He deserves credit also for the fact that in the later decisions the differentiation is invariably made between fixed and current assets.

A brief résumé of valuation under section 40 will serve to bring out the differences between this section and section 261. Fixed assets are to be valued at cost less depreciation; unrealized appreciation of such assets is not distributable profit. Current assets may be valued at their market price although higher than cost—in the case of merchandise intended for sale this means net selling cost. Other decisions are not easily summarized.

To what extent this result is built on a recognition that the old interpretation of section 40 (then section 31) was disregarded in practice is hard to say. In their notes to the commercial code of 1897 the revisers make this significant statement:

> "The general provision in section 40 by no means requires that the then selling price of the fixed assets of a business enterprise should be appraised in order to set up the balance-sheet. Nor does this happen in practice, but rather a reasonable decision is made within the limits prescribed by section 31. This is its proper application and there is no necessity for setting a sharp limit such as is required in corporations by the claim of the shareholder to dividends."

So the tale runs. First the rule is disregarded; thereafter apologists justify the disregard; and finally courts and legislators sanction it.

Although the Simon-Staub analysis of the principles of balance-sheet valuation is indisputably the accepted interpretation of the statute, it is by no means unchallenged as a theory of accounting. Important contributions have been made to accounting since Simon's time and many of them have tended to overthrow the theory of "value to the going concern." This is particularly true of two of the ablest of Simon's critics—Rudolf Fischer and Eugen Schmalenbach.

However, few of the modern writers are greatly concerned with interpreting the commercial code. Fischer, for example, thinks that section 40 is based upon a fundamental mistake in principle.

The fact is that for most purposes the official interpretation of section 40 offers sufficient leeway without too great danger of misleading so that there is no longer any stimulus to legal exegesis. Besides, the corporate balance-sheet dominates the field so majestically that all attention is concentrated on it. And here there have been proposals now and again to discard the rigid provisions of section 261 and to substitute some more flexible provision like that of section 40. These proposals attracted some attention during the war and the inflation period, but they are no longer of any moment. Unless some new economic upheaval occurs, it seems likely that the legal requirements for balance-sheet valuation will remain what they are today.

OTHER TYPES OF BALANCE-SHEETS

We have already noted that German statute law provides for two types of balance-sheets: one is prescribed for corporations, and the other for unincorporated enterprises including the gesellschaft mit beschränkter haftung as well as the partnership. The two differ in principles precisely to the extent that they differ in consequence. The corporate balance-sheet would be regarded by an accountant as extremely conservative, eliminating all unrealized profits. It is created primarily with reference to the rule of law that the surplus as shown on the balance-sheet is distributable as dividends. The non-corporate balance-sheet is more flexible and tends to reflect more accurately the probable monetary value of the enterprise. Since one of the purposes of the latter is to determine the amount payable to a retiring partner, a reason for the difference is apparent.

These are, however, not the only types of balance-sheet recognized in German law. Considerable variation from both types hitherto discussed appears in the balance-sheet prepared for the taxing authorities. A less obvious example arises in the application of section 240 of the commercial code. This section, which applies to corporations, is as follows:

> "If in the preparation of the annual balance-sheet or an interim balance-sheet it appears that half of the capital has been lost, the directors shall forthwith call a general meeting of stockholders . . .
>
> "If the company is insolvent, or if in the preparation of the annual or an interim balance-sheet it appears that its property no longer equals its debts, the directors must place the company in bankruptcy."

The authoritative interpretation is that for this purpose the rules of section 261 (the section stating the bases of valuation for corporation balance-sheets) need not be observed, but that the directors are required to call a stockholders' meeting or institute bankruptcy proceedings only if a balance-sheet prepared according to the much more liberal provisions of section 40 (which applies to all business enterprises) would show a loss of half or of all of the capital, respectively. Here, again, is a recognition of the difference between a type of valuation designed to determine profits available for dividends and a type designed to determine the net worth of a business for other purposes.

CONCLUSION

In America the determination of the amount of net worth or surplus or profit is still subject to considerable variation and to much confusion. To what extent flexibility should be retained is open to question. Judging from German experience we might well make the nature and the extent of rigidity of the rules depend on the purpose for which the balance-sheet is to be used. In present-day American law the chief legal use of the corporate balance-sheet is to control dividends. Such use seems to point to the desirability of a comparatively rigid type of regulation. If the balance-sheet should become legally important in other ways, it may be found necessary to recognize several kinds of balance-sheets. To subdivide is still one way to conquer.